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MiFID II Unbundling Rules: Implications for Asset Managers and Broker-Dealers in the United States

Background

On January 3, 2018, the European Union's revised Markets in Financial Instruments Directive[1] ("MiFID II Directive") and the new Markets in Financial Instruments Regulation[2] ("MiFIR," and together with the MiFID II Directive, "MiFID II") will come into force, replacing the existing Markets in Financial Instruments Directive ("MiFID I"). MiFID II provides an updated and amended framework for regulation of investment services in the European Economic Area (the "EEA") that aims to improve transparency and strengthen investor protections in EEA markets. The new MiFID II rules extend the scope of financial products and trading venues covered by the existing regime, introduce operational and structural changes for trading venues and modify and expand reporting requirements for asset managers subject to the rules.[3]

The MiFID II regime, on its face, will apply only to asset managers with a physical presence or domicile in the EEA (this includes US asset managers with an authorized European subsidiary providing investment services to clients in the EEA). That said, given the regime's complexity and wide-ranging reach, the key provisions of MiFID II will indirectly affect US asset managers that trade financial products through EEA trading venues, or that service EEA clients directly or via sub-advisory agreements with EEA firms that are subject to MiFID II. The extent of MiFID II's impact on any given US asset manager largely depends on the business model of such asset manager and the extent of its client base in the EEA. US broker-dealers also will be indirectly affected by MiFID II if they provide investment research services directly to EEA firms or EEA clients, or to US asset managers that provide services to EEA clients, as discussed further below. The impact of MiFID II on US asset managers and broker-dealers has been mitigated to a significant extent by the recent regulatory relief (as discussed below).

This client memorandum provides a brief overview of key MiFID II initiatives and examines MiFID II's unbundling rules that US asset managers and US broker-dealers should consider in advance of MiFID II's effective date.

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1 Directive 2014/65/EU, available here.

2 Regulation (EU) No 600/2014, available here.

3 Both MiFID I and MiFID II refer to "investment firms," and, in this client memorandum, we generally refer to investment firms providing portfolio management or other investment advice as "asset managers."

Key Provisions of MiFID II

The MiFID II regime's comprehensive overhaul of rules governing the provision of financial services in the EEA will affect a wide range of financial market participants, including asset managers, trading venues and data service providers as well as non-EEA asset managers and broker-dealers that provide investment services to clients in Europe or perform investment activities through a branch in the EEA.[4]

Below is a summary of the key initiatives covered by MiFID II:

- **Introduction of new category of trading venue** – MiFID II creates a new category of regulated trading venue, the organized trading facility ("OTF"), for trading of non-equity instruments, such as bonds, structured finance products, emission allowances and derivatives.

- **Enhanced regulation and governance of trading venues** – MiFID II requires all organized trading to take place on regulated trading venues or by "systemic internalizers" (*i.e.*, firms that deal on their own account when executing client orders outside a regulated market, an OTF or a multi-lateral trading facility ("MTF") without operating a multilateral system), which will now be more widely defined and subject to expanded obligations, in order to increase market transparency.

- **Inclusion of additional financial instruments** - MiFID II extends the types of financial instruments covered by the regime to include certain structured deposits, certain packaged retail investment products and greenhouse gas "emission allowances."

- **Enhanced regulation of commodity derivatives** – more types of commodity derivatives will be subject to regulation under MiFID II. Standardized derivatives (*i.e.*, those that are sufficiently liquid and eligible for clearing) will need to be traded on regulated platforms, OTFs, MTFs or regulated markets instead of over-the-counter ("OTC"). In addition, MiFID II narrows exemptions for commodity firms and establishes mandatory position limits for commodity derivatives and mandatory reporting relating to the size and purpose of positions in derivative contracts.

- **Strengthened investor protection requirements** – MiFID II tightens restrictions on inducements in relation to investment research and establishes enhanced disclosure requirements, in particular in relation to costs to the client (*e.g.*, pre- and post-trade information on fees and commissions paid and received by the asset manager) and best execution.

- **More comprehensive transaction reporting by firms** – under MiFID II, transaction reporting requirements will now apply to all financial instruments. The MiFID II regime also mandates that investment firms submit post-trade data to regulated third parties (such as approved publication

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4 Article 1o of the MiFID II Directive.

arrangements ("APAs"), approved reporting mechanisms ("ARMs") and consolidated tape providers ("CTPs")) that will be reporting data on behalf of investment firms. Transaction reports will also need to reflect additional information, such as the identity of individuals (and computer algorithms) responsible for the investment decision and the execution of the transaction.

- **Stricter governance and accountability requirements for investment firms** – MiFID II imposes new requirements for corporate governance and vests in a firm's "management body" responsibility for defining, approving and overseeing the firm's corporate governance arrangements "that ensure effective and prudent management of the investment firm including the segregation of duties in the investment firm and the prevention of conflicts of interest, and in a manner that promotes the integrity of the market and the interest of clients." Remuneration of client advisory staff will be more strictly controlled, criteria for qualified senior management will be increased and the requirements in respect of the compliance function will be strengthened.

- **Increase in pre- and post-trade transparency obligations** – MiFID II imposes a new volume cap mechanism (to avoid negative effects on the price formation process, by imposing a double cap, whereby a volume cap is applied to each trading venue that uses waivers and an overall volume cap is also applied) and limits the number of equity and equity-like trades allowed to take place under waivers. MiFID II also requires that trading venues unbundle (or disaggregate) pre- and post-trade data provided to the public.

- **Greater regulation of algorithmic trading** – MiFID II requires firms that provide direct electronic access and engage in algorithmic trading, including high-frequency algorithmic trading, to have effective systems and risk controls in place. To that end, firms will be required to set order limits and use circuit breakers to limit or temporarily halt trading so as to avoid erroneous orders.

- **Third country access to the EEA** – under MiFID II, non-EEA firms will be allowed to provide cross-border services to professional clients and eligible counterparties without establishing an EEA branch if their home jurisdiction's regulatory regime is deemed equivalent and the European Securities and Markets Authority (ESMA) agrees to include the firm on its register of permitted firms. However, if such cross-border services are directed to retail clients in the EEA, an EEA branch may be required in each member state where the investment firm will operate. Additionally, access to EEA central counterparties ("CCPs") by third-country trading venues will be more strictly regulated under MiFID II.

The MiFID II Unbundling Requirement Affecting US Asset Managers and US Broker-dealers

MiFID II prohibits asset managers from accepting "fees, commissions or any monetary or non-monetary benefits paid or provided by a third party," except for minor, non-monetary benefits that enhance the quality of service provided to the client and do not impair the firm's duty to act honestly, fairly and professionally in furtherance of the best interests of its client.[5] MiFID II provides an exception for research services provided by third parties as long as those services are paid for directly by the asset management firm either out of its own resources or from a separate research payment account ("RPA")[6] controlled by the firm (this separate charging approach is also known as "unbundling"). Research paid for directly or via RPAs would be treated as not involving any direct pecuniary benefit to the asset manager and, therefore, would not be viewed as inducement. Funds for RPAs can be obtained in two ways, either (i) when the asset manager directly bills a client with specific research charges or (ii) when the research provider imposes a separately priced charge for its research in addition to its dealing commission, with the research charge being remitted to the RPA controlled by the asset manager. In either case, as a practical matter, RPA arrangements would require client consent, and various conditions would need to be satisfied. Under these new rules, payments for investment research through dealing commissions or commission sharing agreements (such aggregated amounts are often called "soft dollars") would not be allowed unless made through RPAs.

Research that is not overly tailored or bespoke in content, or limited in the way it is distributed and accessed, could qualify as minor, non-monetary benefits and, as such, would be exempt from the new provisions and would be permitted as long as it is capable of enhancing the quality of service provided to the client in accordance with relevant standards. An example of such research would be written material from a third party commissioned and paid for by an issuer to promote a new issuance. Other examples would include non-substantive material or services consisting of short-term market commentary on economic statistics or company results, or information on upcoming releases and events, which are provided by a third party and contain only a brief summary of its opinion on such information that is not substantiated and does not include substantive analysis.

These new rules would have had significant implications for US assets managers (buy-side participants) and US broker-dealers (sell-side participants) due to the potential conflict the rules pose with existing US rules, absent the regulatory relief further described below.

US broker-dealers

Under the US Investment Adviser Act of 1940 (the "Advisers Act"), US broker-dealers that provide investment advice that is "solely incidental" to their brokerage services and that receive no "special compensation" for it are exempt from the definition of investment adviser. As such, US broker-dealers that provide research services as part of their brokerage business and that are paid for the research through dealing commissions fall within this exemption.

5 Article 24(7) of MiFID II Directive and Article 11 of Commission Delegated Directive (EU) 2017/593.

6 Article 13 of Commission Delegated Directive (EU) 2017/593.

However, absent the regulatory relief (as discussed below), if broker-dealers were to be paid separately for research in so-called “hard dollars” by an asset manager or through RPAs, as will now be required under MiFID II for recipients that come within the purview of the new rules, they would risk being treated as receiving “special compensation” and required to register as investment advisers. Registration as investment advisers would give rise to new fiduciary duties (by creating a fiduciary relation between the broker and its research clients) and expanded reporting obligations, such as more onerous trade-by-trade written disclosure and consent requirements. US broker-dealers that provide investment research services, either directly to EEA asset managers and EEA clients or to US asset managers that have EEA clients, would have been affected by the unbundling requirement.

US asset managers

For US asset managers that provide cross-border investment services, the unbundling requirement could potentially raise issues regarding the application of the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (“Section 28(e)”), since Section 28(e) protects asset managers that pay for research with “soft dollars” from claims of excessive commission payments and cross-subsidization (a practice where higher commissions from some clients may be used to fund research used in the management of other clients’ accounts). In effect, the Section 28(e) safe harbor enables US asset managers to use client commissions to purchase “brokerage and research services” without breaching their fiduciary duty.

US assets managers that comply with MiFID II’s unbundling requirement for research services provided to their EEA clients should continue to be able to pay with client dealing commissions for research completed for non-EEA clients not subject to MiFID II, in reliance on Section 28(e), although they may need to consider “ring-fencing” their trading in MiFID II accounts.

The difficulties may, however, arise if a US asset manager decides, either for compliance or business reasons, to use a MiFID II-type RPAs not just for its EEA business, but also in connection with research done for its US business. Absent the regulatory relief (as discussed below), this could disqualify the asset manager from the Section 28(e) safe harbor, since research payments in the form of a research fee charged alongside a trading commission may no longer meet the definition of “commission” for Section 28(e) purposes. In fact, MiFID II specifically provides that research fees charged alongside commissions are not themselves commissions and they must be deposited into an RPA controlled by an asset manager in order to be used to purchase research. Since balances in RPA accounts are not commissions, the use of those balances to pay for research may be incompatible with Section 28(e) requirements.

Market observers have suggested that while some asset managers may be able to obtain consent from their clients to enter into payment arrangements outside of Section 28(e), others (such as those with client accounts subject to the Investment Company Act of 1940 or the Employee Retirement Income Security Act of 1974) are only permitted to use payment arrangements falling within the Section 28(e) safe harbor and would not be able to use outside arrangements, such as RPAs, to pay for research. Using the

RPA-type account across the board (*i.e.*, for both MiFID II and non-MiFID II accounts) may implicate certain other disclosure obligations arising out of potential cross-subsidization issues.

Other unresolved issues that may arise as result of imposition of the unbundling requirement include:

- the treatment of surplus research fee funds left over in RPA accounts as client money and the authority to fund such accounts in light of the fact that the custody rule under the Adviser Act prohibits US investment advisers from holding client funds in custody (which potentially could be the case if they used RPAs) absent compliance with the custody rule. If the unspent balances in RPA accounts were to be treated as client funds, then US investment advisers would be required to comply with the custody rule's costly and burdensome reporting and recordkeeping obligations (including the surprise examination requirements triggered in certain situations when the adviser uses client money);

- whether research-sharing arrangements between affiliates of an asset manager comply with prohibition on cross-subsidization, whereby research funds from one client's RPA are used not only for the management of that client's RPA, but also for those of other clients that have not necessarily contributed to the RPA;

- how research pricing and valuation decisions can be explained and reconciled, which is relevant for purposes of the reasonableness determination under Section 28(e) and inducement concerns under MiFID II, if the same research is potentially priced differently for MiFID II and US accounts; and

- the potential impact of introduction of RPAs on the order flow in block trades where MiFID II accounts and other accounts are aggregated, and whether such trades may have to be segregated, in particular in cases of market moving or partially filled orders.

Evolving Market Practice

Certain large US asset managers are reported to have already indicated that they will absorb the cost of research and will not pass it on to their affected clients. One US asset manager is reported to have indicated that it will use a credit support annex to isolate research costs and then reimburse clients from its own balance sheet. To control costs, some other assets managers are reported to be planning to create in-house research departments to support their asset management arms.

As result of these impending changes, market commentators have noted that smaller, independent firms focused on investment research may be unable to incorporate the cost of research and, as a result, these firms may no longer be competitive in the market. The changes may also generally result in the decline of research available as asset managers will try to limit their expenditures on external research and focus more on cost and quality.

Regulatory Responses

US and EU regulators, in particular the US Securities and Exchange Commission (the "SEC") and the European Commission (the "EC"), have acknowledged the potential for conflicts between existing US rules and MiFID II and have made efforts to provide relief to market participants that are required to comply with two conflicting regulatory regimes. In particular, on October 26, 2017, both the SEC and the EC published clarifications in respect of certain provisions of MiFID II—the former in the form of three related no-action letters,[7] and the latter in the form of an FAQ.[8]

The SEC no-action letters provide in effect that, subject to certain conditions:

- Broker-dealers, on a temporary basis,[9] may receive research payments from asset managers subject (either directly or by contractual obligation) to MiFID II in "hard dollars" or from RPAs from MiFID-affected clients without being treated as investment advisers. For purposes of this relief, a non-EU-domiciled investment manager would be treated as subject to MiFID II by contractual obligation where an asset manager directly subject to MiFID II directly or indirectly delegates portfolio management to the non-EU-domiciled manager and that manager is contractually required to comply with MiFID II or equivalent protections (*e.g.*, setting research budgets, accounting for research inputs, and having systems and controls to ensure that the receipt of research does not give rise to certain conflicts of interest) in managing accounts under the delegation.

- Asset managers, while accommodating the differing arrangements regarding the payment for research under MiFID II's unbundling requirement, may continue to aggregate orders for mutual funds and other clients as long as they implement procedures designed to prevent any account from being systematically disadvantaged by such aggregation.

- Asset managers may continue to rely on the existing Section 28(e) safe harbor when paying broker-dealers for research through RPAs, provided that all other applicable conditions of Section 28(e) are met.[10]

The SEC no-action relief, albeit limited in scope and, in the case of relief for broker-dealers, duration, is a welcome development that should "reduce confusion and operational difficulties that might arise in the transition of MiFID II's research provisions"[11] and facilitate compliance with the new EU rules, without

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7 The SEC no-action relief letters and the accompanying SEC press release, dated October 26, 2017, available here.

8 The EC's FAQ entitled "MiFID II: Interaction with Third Country Broker-Dealers," dated October 26, 2107, available here.

9 The broker-dealer relief will expire 30-months from MiFID II's implementation date (January 3, 2018).

10 SEC press release, October 26, 2017.

11 *Id*.

any substantial changes to existing US regulatory approach. The SEC staff has made clear that, in relation to the temporary broker-dealer relief, they will "monitor and assess the impact of MiFID II's research provisions on the research marketplace and affected participants in order to determine whether more tailored or different action, including rulemaking, is necessary and appropriate in the public interest."[12] With respect to Section 28(e) relief, the staff noted that such relief may be subject to modification and revocation at any time, and would depend on the specific facts and circumstances at hand.

The EC's FAQ addresses certain concerns related to MiFID II's effect on third-country broker-dealers' provision of research and execution services to EEA firms. The FAQ makes clear that third-country broker-dealers may receive combined payments for research and execution as a single commission when providing such services under MiFID II, provided the payment attributable to research can be separately identified. In addition, while third-country broker-dealers are required to identify a separate fee attributable to research in cases where these services are paid by an asset manager out of an RPA or directly out of its own resources, this fee does not need to be included in a separate research invoice and may be determined by means of consultation with third parties, including the third-country broker-dealer.

Conclusion

With MiFID II's effective date quickly approaching, the coming months will no doubt shed light on the practical implications of MiFID II. Market practice may be varied at first, but regulatory responses should lessen the existing uncertainties and lead to a more consistent market approach.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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12 *Id.*